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MEMORANDUM: Impact of Higher Oil Prices On Inflation And Output

1. The economic outlook for the developed countries is now more uncertain than at any time since World War II. With virtually all segments of the population having been hurt and expecting conditions to worsen, psychological factors are becoming increasingly important. Before the recent price hikes there was hope that the world economy would grow somewhat in the first half of 1975. Now the potential for the economic crisis to deepen is real and growing. If prices rise further, the chances of a severe world wide recession would be increased.

2. The rise in oil prices since October 1973 has been an important factor in the sharply reduced economic output in the world's major industrial countries (see Table 1). These countries now have to pay an additional $60 billion annually -- and more next year -- for their oil imports. The effect has been to reduce purchasing power and to raise prices and costs at the same time. Higher oil prices alone have been responsible for increases of 3.6% to 12.0% in the wholesale price level so far this year in major western countries (see Table 2). To combat inflation many governments have been forced to adopt more restrictive policies whose effects reinforced the loss of purchasing power due to higher oil prices. The contractionary impact on consumer purchasing power has been reflected in a sharp slump in retail sales and industrial output. The downturn has been particularly marked in durable consumer goods industries (see Table 3).

Table 1

Economic Outlook 1974: Real GNP Growth

	OECD Forecasts Made In	
	Oct 1973	July 1974
United States	2.5	-0.5
Japan	8.6	-1.5
West Germany	3.5	1.7
France	5.7	4.7
United Kingdom	3.6	-2.0
Italy	7.5	3.5

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Table 2

Impact of Oil Price Hikes On Wholesale Prices
Jan-Jun 1974

	Percent Increase in Wholesale Prices	Amount Directly Attributable to Higher Oil Costs 1/
United States	16.2	4.6
Japan	13.3	10.5
West Germany	9.5	5.9
France	19.6	3.6
United Kingdom	15.7	5.0
Italy	24.0	12.0

1/ Calculated from input-output tables.

Table 3

Industrial Production: Percent Change Since November 1973

United States	-1.8
Japan	-6.2
West Germany	-3.8
France	+3.2
United Kingdom	-3.3
Italy	+4.4

3. A growing body of economists is convinced that world economic activity will decline in the months ahead. Even the most optimistic foresee only a weak recovery next year, with growth rates far below past recoveries. The Wharton Business School, one of the most respected forecasting groups in the US now believes that there will be no recovery in US output until early in 1976, and have indicated that there is a real possibility of a very severe slump next year. The situation could be worse -- they did not factor in the recent oil price hikes and assumed constant oil prices.

4. Oil prices are a major cause of the rapid worldwide inflation. Further oil price increases will feed inflationary expectations. Higher oil prices already have greatly accelerated the rise in prices (see Table 4). In addition to the direct impact on consumer prices, high energy costs have sharply boosted industrial and agricultural prices. This in turn is bringing about higher wages in industrial countries, as workers strive to maintain their real incomes. This will boost prices still more, since these wage increases will be reflected in higher unit-labor costs.

Table 4

Economic Outlook 1974: GNP Price Deflator

	OECD Forecast Made in	
	Oct 1973	July 1974
United States	6.1	9.0
Japan	9.0	23.0
West Germany	6.8	7.0
France	7.5	11.5
United Kingdom	5.6	10.5
Italy	9.4	15.3

5. The danger of a deeper recession is made more real because burgeoning trade deficits have severely limited the options open to economic policymakers. Countries such as Italy and Denmark are already having great difficulty financing their oil payments and eventually will be forced to severely reduce their non-oil imports to avoid financial collapse. As countries strengthen their restrictionary policies, the result will be reduced demand for inputs from other nations. Japan squeezed its economy so tightly in the first half of the year that GNP fell 4%.

6. A major element of uncertainty is the stability of the banking structure. Unprecedented financing demands are being placed on commercial banks at a time when all

major industrial countries are employing very restrictive monetary policies in their struggle to hold down inflation. In addition to the demand for large international loans, sharply rising inventories and manufacturers' growing inability to pass along all the cost increases have sharply boosted the demand for funds. In Japan, for example, declining business liquidity has already caused a sharp rise in bankruptcy. In Germany, major losses in foreign exchange dealings, have forced a number of banks to close.

7. Indeed, because of the major shift in the flow of funds, major business bankruptcies may be inevitable in those countries where the balance of trade is badly in deficit -- the United Kingdom, Italy, Denmark, and several smaller industrial nations. The Economist of London has indicated that these nations will soon be forced to choose between widespread business failure and massive unemployment or abandonment of anti-inflation policies and acceptance of massive government deficits. Both of the major parties in the United Kingdom are preparing the electorate for major economic difficulties, saying that the UK faces its darkest hour since early in World War II. This prospect is being reflected in the worldwide decline in share prices, which is in itself depressing consumer confidence and limiting companies ability to obtain vitally needed financing. The London Stock Market is now more depressed than it was during the blitz.

Longer-Term Effects of High Oil Prices

Growth and Energy Demand

8. The present high level of oil prices will have far-reaching consequences for the world economy even if world economies somehow adjust to the short-term difficulties. Future output growth will be much slower than in the past. Because high oil costs will shift investment into development of less efficient alternative energy sources and energy-saving manufacturing processes, new additions to industrial capacity will be limited. Japan, for example, is planning to restrain output until late 1975 -- holding growth close to zero -- and then planning for output rises far below the 9-10% average of the past decade.

9. The result will be a slow rate of economic growth and an even slower rate of growth in energy consumption. Alternative energy sources probably will grow faster than total energy demand. World oil demand will be hard-hit and oil import demand will probably fall. Germany and France, Europe's biggest oil consumers, have developed plans to greatly reduce the future rate of growth of energy consumption. These plans call for a much greater reliance on nuclear energy and reduction in oil imports over the next decade. Because of growing North Sea and Alaskan output, import needs will fall in both the UK and the US, even if they do not restrict consumption as severely as Germany and France.

Inflation

10. The outlook for a substantial slowing in the current high rate of inflation is poor in large measure because of the adverse impact of high energy costs on the extremely tight world food situation (see Table 5). Modern agriculture is highly dependent upon large amounts of energy-based inputs, especially nitrogen fertilizer. Because of the quadrupling of oil-based fertilizer prices, food prices will have to undergo a further hefty increase over the next few years if farmers are to be able to meet the world's demand for food. Continued rapid increases in food prices, in turn, will fuel large wage demands in industry.

Table 5

Consumer Price Trends

	Percent Change From Previous Period At Annual Rates	
	Aug-Nov 1973	April-June
United States	10.0	11.0
Japan	14.0	32.0
West Germany	4.2	7.6
France	9.9	15.0
United Kingdom	8.7	19.0
Italy	10.1	19.9

11. Several factors will serve to boost industrial prices as well. Because of slower capacity growth, any upturn in demand resulting from a reversal of current restrictive demand-management policies would run into capacity constraints and generate increased inflationary pressures. Given the highly unionized structure of manufacturing in most countries and push by labor to at least maintain their real incomes, higher wage costs will necessarily be reflected in manufactured goods prices.

Impact on the Developing Countries

12. The impact of high oil prices on the developing countries is particularly severe. These nations have little scope for economizing on oil use since only a very small amount of their consumption is for non-essential purposes. The impact has been particularly cruel in those countries that have been depending upon modern fuel based inputs to boost food production. Fertilizer price rises and shortages have reduced crops this year, as have shortages of fuel for tractors and trucks in rural areas.

13. Several of the poorer developing countries have been walking a thin line in trying to feed their burgeoning populations. Most recently they have pinned their hopes to the new high-yielding varieties, which require carefully measured and timed fertilizer applications. The recent disruption of fertilizer supplies and skyrocketing prices may help push some of those countries over that line. Because poor weather has reduced output and world grain stocks are at their lowest levels in the last 20 years, traditional exporters such as the US do not now have supplies to provide to avert widespread food shortages in the poorer countries this year. Many well known world food experts such as Norman Borlaug and Lester Brown expect lasting famines to develop in the poorer countries this year. This year in India, hundreds of thousands will almost certainly die from malnutrition and related health problems.

14. The long-run impact on the developing countries will be serious even for those who do not face immediate food problems. The slump in output in the industrial countries will inevitably result in reduced demand for LDC exports of raw materials and declining raw material prices. Indeed, prices

for such raw materials as copper and hides have already fallen to less than half their levels of a year ago. Current efforts by groups of raw material suppliers to emulate OPEC will probably fail, particularly if demand remains depressed for a substantial period. At the same time, inflation is continuing to boost the cost of capital goods and food imports.

15. The result probably will be much slower growth and a widening of the already large gap between developing and developed nations. Although the developing countries are pressing the industrial-states for more aid, increased lending from the industrial countries, who will continue to face great balance of payments and employment problems, seems unlikely. One result will be a growing awareness by developing nations that high oil prices must be reduced and that this is in OPEC's power.

Political Implications

16. The political repercussions of the industrial west's spreading economic malaise could prove to be particularly serious. Growing economic nationalism is to be expected as each nation tries to insulate itself from outside problems while simultaneously attempting to corrent balance of trade deficits. Many observers fear that economic nationalism will inevitably affect the world's trading system and eventually spill over into such areas as mutual defense. They believe that nationalistic responses will be successful for only a few, since each nation will only be able to improve its position at the expense of the others. As a result, the economic problems of the weaker western nations could easily worsen and cause growing political instability.

17. In Western Europe high oil prices have compounded the political difficulties of governments attempting to resolve the conflicting demands of labor, business, farmers and consumers. Inflation and anti-inflation austerity programs are already having an adverse impact on political stability in Italy and the UK. France is also susceptible to similar unrest, even if for the moment organized labor is emphasizing responsibility. To most officials in Europe, the prospect

of growing unemployment resulting from massive payments outflows to oil producers is even more frightening than inflation. This is particularly true in France and Italy, where large well organized Communist and Socialist parties are competing for power.

18. In the less developed nations, slowing economic growth combined with sharply growing population, could create socially explosive conditions. Rapidly growing unemployment -- a likely consequence of rapid urbanization and slower growth -- would provide fertile ground for radical elements. For many of the poorer and heavily populated countries, governments will probably face a growing inability to function.